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[GUEST POST] 7 TAXATION RISKS WITH OFF-SHORE FUNDS IN INDIA

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Background

Foreign investment owing into India is primarily pooled and managed in offshore jurisdictions. In an Alternate Investment Fund (AIF) structuring, it is seen that the domestic fund managers and sponsors prefer to structure their

fund through an intermediate offshore pooling vehicle and accordingly strategize the investments and contributions from such an offshore entity instead of direct investment to the domestic fund.

As per the statistics of the USD 43 billion of foreign direct investment (FDI) inows which India received in FY17, $24 billion was invested via Mauritius and Singapore. Both these jurisdictions have emerged as the preferred destination for fund managers to set up their operations.

Owing to the uncertain nature of Indian income-tax laws and inconsistency in the judicial outlook towards the interpretation of the same, there are certain tax risks that may arise to an offshore fund. Time and again, authorities have claried the tax regime in relation to offshore funds to remove the ambiguities and make the regime for investment-friendly. However, still, there are certain ambiguities which in case of any claim by authorities may give rise to conicting opinions. This write-up analyses the 7 of such primary risks involved in tax regime of offshore funds under Indian tax laws.

1. General Anti Avoidance Rule ('GAAR'): a threat to commercial structuring?

GAAR is an anti-avoidance measure that gives the tax department blanket power to scrutinize transactions structured to deliberately avoid paying tax in India and declare it as 'impermissible avoidance arrangement'. With GAAR, the demarcation between "tax evasion" and "tax avoidance" has been completely done away with and the "permissible tax avoidance transactions" are also impermissible now under GAAR. It is to be noted that GAAR has given wide discretionary power in the hands of tax authorities. Conferring so much power apprehends the misuse and abuse of powers.

Basis case to case facts and manner of structuring, offshore funds may get trapped under GAAR. Also, the Expert Committee on GAAR headed by Dr. Parthasarathi Shome in their report on the implementation of GAAR in 2012, had specically categorically recommended that GAAR provisions should not be invoked in case of pooling of the funds. However, unfortunately, the same has not been included in the nal GAAR framework. The way GAAR has been formulated, it induces an element of subjectivity and therefore instead of imparting certainty, more uncertainty and litigation can be anticipated.

2. Taxation of Indirect Transfers: Lessons from Vodafone Verdict

The famous Vodafone case witnessed a panorama of varied judicial opinion on the interpretation of Section 9 of Income Tax Act, 1961 in relation to taxation of indirect transfers occurring in offshore jurisdictions and thereby gave rise to conicting opinions by the tax authorities and judicial forums. Although the Apex Court's verdict is still considered as a milestone step to regain the condence of foreign investors on Indian judicial forums, at the same time it left tax authorities unsatised backed by a huge revenue loss. Consequently, Section 9 was amended to provide that any share or interest in a company or entity registered/incorporated outside India shall be deemed to have been situated in India if the share or interest derives, "directly or indirectly", its value substantially from assets located in India.

With an exception to Category I and II FPIs, the amendment will be uniformly applicable to all other entities.Considering aforesaid, if an investor sells the shares held in the offshore fund then the gains are likely to be subject to tax in India on the basis that such sale indirectly results in the transfer of a capital asset situated in India as the Fund would be deriving its value substantially from Indian assets. Also, the indirect transfer tax would get triggered for the Fund on the transfer of shares of special purpose vehicle which derives value from assets located in India. Therefore, there is a

reversal of situation post the recent amendment to Section 9 as compared to the extreme position taken by the Apex court in the Vodafone Judgment in favor of the foreign investors previously.

3. Association of Persons (AOP): Co–investments to trigger AOP?

AOPs are recognized as separate taxable entities under Section 2(31) of the Income Tax Act, 1961. As per judicial pronouncements, "Common Purpose" and "Income Oriented" are the essential determining characteristics of an AOP, but not the sole criteria and each case needs to be analyzed on an individual basis. Although, there are no direct judgements or instances where a co-investment by an offshore fund along with an onshore fund has been categorized as an "AOP", however basis the wide ambit of AOP category and the view taken by authorities in relation to other entities coupled with the spree of recent amendments to tax laws and treaties, it is very much possible that any such co-investment may be argued to be brought within the scope of AOP and hence taxable in India.

One of the reasons which support this view is the fact that in most of the off-shore funds, control rests with the domestic manager who in turn manages the on-shore fund too, thereby giving rise to the possibility of "common purpose".

4. Place of Effective Management (POEM): Whether it nullies the relaxation on the resident status requirement for managers?

As per the last CBDT clarications the fund management activity carried out through an eligible fund manager in India by an eligible investment fund does not constitute business connection in India of the fund and also does not lead to the residence of the fund in India. Thereby making them non-taxable under Section 9. However, with the POEM (Place of Effective Management) criteria, again the debate on the resident status of an offshore fund under Indian tax regime has started.

POEM criterion stipulates that if the place of effective management in India, the entity will be treated as an Indian resident and its global income will be taxable in India. With the recent guidelines, it has been claried that POEM is a place where key management and commercial decisions that are necessary

for the conduct of the business of an entity as a whole are, in substance made. The concept of POEM and residential status for "offshore funds" are extremely crucial as well as ambiguous at the same time considering the various players involved in a typical fund structure, who may be situated in different jurisdictions. It is, therefore, advisable t have a clear demarcation of activities (specically decision-

making activities) so as to expressly accord the POEM of the Fund as per the desired commercial objective, thereby avoiding unfavorable tax treatments.

5. Transfer Pricing get triggered?

Transfer pricing regulations have been at the vanguard over the last few years due to the increasing number of controversies resulting out of tax structuring through offshore jurisdictions and involving multiple layers of related entities. Transfer pricing as we know refers to the pricing of international transactions between two associated enterprises. "Associated Enterprises" include the enterprises with direct or indirect participation (through one or more

intermediaries) in management, control or capital. As per Section 92 of the Income Tax Act, 1961 any income arising from an international transaction shall be computed having regard to the arm's length price.

In case of overseas funds, if the fees charged by the Indian advisory companies are not considered to be at arm's length, then there could be adverse implications under the transfer pricing provisions for the resident advisor. Similarly, if sponsor and manager are the same parties, then also the transactions between them (if one of them is a non-resident) may trigger transfer pricing norms. It is hence always advisable to clearly demarcate and keep all such transactions at arm's length.

6. Safe Harbor Rules – safe enough?

To encourage fund management of offshore funds from India, the Finance Act, 2015 has introduced Section 9A in the Income Tax, 1961 to provide for a regime of onshore management of offshore funds.

To be eligible and qualify for the benets under the Section 9A the fund manager needs to qualify as an eligible investment fund and an eligible fund manager. The fact is there are too many eligibility conditions relating to annual reporting requirements, investor diversication, tax residence and so on which muddy the waters and negate the good intentions of the government.

7. GST: a wrinkle in the system?

The typical AIF structure comprises of both domestic and offshore investors. Under the existing GST regime it should be noted that when AIFs pool investors at an offshore location to invest in India, the same is construed as export of services which is clearly exempt from GST implications. However, tax clarity for AIFs managed by India domiciled asset managers is yet to be provided as these AIFs even if they are pooled offshore are not exempt from GST. Any such implications will add to the cost of management and can create an impediment to the ongoing tern of 'manage in India'.

In the absence of any clarity from the Government on the incidence of GST on offshore funds managed by resident managers, it will be advisable to structure the fund and appoint the non-resident manager to avoid any additional tax burden which may possibly trigger with any contradictory view from the Government or tax authorities in future.

Concluding Proposition

As aforesaid, time and again authorities have appropriately claried the tax laws so as to remove ambiguities in tax regime under Indian laws. However, with the recent conicting judicial and legislative opinions on the treatment of tax on non-residents, retrospective amendments to the Income Tax, Act,

1961 and the lack of clarity under GST regime, the uncertainty in the tax treatment of such offshore entities have increased considerably. It is expected that like recent POEM guidelines, Government will come up with clarications in relation to other risks and uncertainties as well in near future and clear out all the airs of doubts, thereby help in regaining the condence of market players and making the tax regime in relation to offshore funds more certain!